



OFFICE *of the*
RAIL REGULATOR

REVIEW OF UTILITY REGULATION
SUBMISSION BY THE RAIL REGULATOR

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Review of utility regulation

Introduction

1. While transport is excluded from the review of utility regulation announced by the President of the Board of Trade on 30 June, she indicated that the review would consider whether there are lessons to be learnt from other regulatory experience, to inform the development of regulatory principles of general applicability. In this submission, I set out a number of areas where, I believe, the experience of approaches adopted by my Office may be of such general applicability. Given that the framework of railway regulation is being separately reviewed by the Deputy Prime Minister, who will be issuing a White Paper next year, this submission does not seek to cover all aspects of the current regulatory framework for railways.

Regulatory duties, objectives, and relationship to Government policy

2. The terms of reference for the review emphasise the importance of regulation of the utility industries being open and predictable, fair to all consumers and to shareholders, promoting the Government's objectives for the environment and sustainable development, while providing sufficient incentives to managers to innovate, raise standards and improve efficiency. I support these objectives.
3. My specific objectives as Rail Regulator must, of course, be determined within the functions established by statute and the duties placed on me. In the case of the Railways Act 1993, there is no hierarchy in statutory duties (although the Channel Tunnel Rail Link Act 1996 does place an overriding duty on me to exercise my regulatory functions in such a manner as not to impede the performance of any development agreement in respect of the Link).
4. My statutory duties include a number (such as protecting the interests of users, promoting economy and efficiency, and promoting competition) which are similar to those in other utility statutes. Some are specific to railways: for example, the duty to have regard to the impact of my decisions for the Franchising Director's budget recognises the important role of Government subsidy in the rail industry. Regulatory decisions inevitably involve a trade-off between different objectives, and the need to have regard to taxpayers, as well as users and the regulated companies themselves, adds a further dimension. It is therefore important for me to have a full appreciation of

Government policy, both narrowly in respect of future support for subsidised rail services and more generally for transport policy, in framing my own objectives.

5. I recognise that an absence of primary and secondary duties, and a duty in respect of the financial position of regulated companies which is worded somewhat differently from other industries¹, means that the framework of railway regulation is already somewhat different from that of other industries, and already requires a balance to be struck between the various statutory duties. The existing structure effectively requires me to achieve the best deal possible for passengers and freight users and for promoting the use and development of the railway network within the constraints of the duties relating to the financial position of Railtrack and the Franchising Director. However, I recognise that there is understandable public concern about the priority given to consumer interests particularly in an industry in receipt of a large amount of subsidy and that there is therefore a case for putting my duty to protect the interests of users as primary duty.
6. I welcome the endorsement of the principle of arm's length independence of regulators in the President of the Board of Trade's statement. I believe that the benefits of independent regulation are well established as a basis for gaining private sector commitment to and funding for improvements in services. But while the Rail Regulator is an independent Office holder bound by existing statutory duties, and (unlike the Franchising Director) not subject to instructions from the Secretary of State, the Government's aims for the future of rail services are important considerations for me.
7. Unique among regulators, and reflecting the considerable amount of industry restructuring (including privatisation) which still had to be carried out, the Act placed me under a duty (until 31 December 1996) to exercise my functions taking account of guidance from the Secretary of State. I have considerable powers to bring to bear to achieve public interest objectives within existing legislation, but I recognise the need for independent regulation of railway operators to be responsive to wider Government transport policies. I welcome moves by Government to indicate the improvements it wishes to see in the railway, given the public finance provided. Although the duty to take account of guidance has now lapsed, I therefore believe that there is benefit in perpetuating a mechanism for clarifying, and documenting, the relationship between

¹ "to act in a manner which he considers will not render it unduly difficult for persons who are holders of network licences [ie principally Railtrack] to finance any activities or proposed activities of theirs in relation to which the Regulator has functions..."

the Secretary of State and the Rail Regulator to ensure that objectives are properly understood on both sides. I am discussing with the Deputy Prime Minister a Concordat, to provide a basis for cooperation and communication between us in the public interest.

8. In regulating Railtrack, I carry out a role traditionally associated with the regulator of a network utility. I seek to ensure that it does not exploit its monopoly position, by setting its prices and monitoring (and if necessary enforcing) the maintenance and improvement of its quality of service to rail users. However when it comes to regulating operators (of trains, stations and light maintenance depots) my role is more restricted, focusing on issues of customer protection, in particular the maintenance of network benefits, and anti-competitive practice.
9. There are obviously strong similarities between regulating Railtrack and other network industries, in particular NGC and Transco, which are also vertically separated from their relevant service providers. In determining the appropriate level and structure of charges for Railtrack at the next periodic review, the methodology I adopt will have to address many of the same issues, for example, the cost of capital, the size of the regulatory asset base and the treatment of capital expenditure in respect of the RAB. In order to ensure that access to finance for Railtrack is available on broadly comparable terms to other network utilities, I consider that it is important to develop and maintain a broad similarity between regulatory frameworks.
10. There is however one respect in which my functions are significantly different from those of other regulators. Under the terms of the Railways Act, any contract for access to a railway facility (the network, stations or light maintenance depots) is void unless approved by me. In scrutinising agreements before approval, I seek to ensure that the commercial interests of the parties have not prejudiced achievement of the overall public interest.
11. Significantly, my proposals following the periodic review will appear in these access agreements between Railtrack and the operators and not in Railtrack's licence. The effect of this is to remove from Railtrack the protection afforded to other network utilities of a reference to the MMC which a modification to its licence would provide, in the event that it was not content with my proposals. There could be other advantages, in terms of achieving a more appropriate structure of charges within an overall price cap, if some of the charging arrangements were contained in Railtrack's licence rather than in access agreements. I therefore propose, as part of the periodic review process, to consult on the role of a licence condition in controlling overall

level of charges. There may however be legal constraints which restrict my ability to use the licence as a means of regulation where the access regime can be, or has been, applied. If this is the case, there could be a case for legislation to modify the Railways Act in order to bring the regulatory controls in respect of Railtrack's charges into line with those of other regulated network industries.

12. Access agreements are bilateral contracts between two parties, they contain a common set of multilateral Access Conditions. These Conditions set out, for example, the basis on which train operators and Railtrack work together to develop a timetable, or to make changes to the network which may affect more than one operator. Although I have no direct powers to modify access agreements once they are approved, I have generally only approved agreements if they contain provisions which allow certain terms in the agreements to be reopened, in specified circumstances². The Access Conditions also contain provisions which allow me to make changes following appropriate consultation, if I consider that such changes are required to promote the public interest.
13. I recognise that powers by which regulators can make unilateral changes to commercial contracts should be exercised only in clearly defined circumstances, and in accordance with due process. There may, however, be circumstances in other industries where similar powers to change the arrangements for all operators in an industry may be required to protect the public interest.
14. The enforcement powers which I have as Regulator include the ability to levy unlimited fines on licence holders. I have already levied fines in respect of National Rail Enquiry Service for failure to achieve the minimum target set of answering 90 per cent of telephone calls. Fines will continue to be levied until this target is consistently achieved. The fines are based on a 'sliding scale' to ensure that very poor performance is penalised more heavily than performance which just missed the target.
15. I believe that fines can provide additional incentives on licence holders to comply with the terms of the licence and performance targets established under it. Indeed in some cases such as NRES, which is a small but important part of the business of all passenger train operators, I consider that the use of fines is a more proportionate and immediate response to licence breaches, and hence more likely to be in the customers' interest, than say the withdrawal of a train operator's licence. At present the use of

² (For example, it is such a reopener which enables me to introduce the conclusions from my next periodic review of Railtrack's charges in 2001 into access agreements which run to at least 2003 and in some cases longer.)

finer gives no direct benefits to consumers (in the form say of a rebate such as they might receive for poor reliability or punctuality under the Passenger Charter arrangements, or reductions in charges following modification to price limits following as in the case of Yorkshire Water). The fines levied are currently paid directly to the Exchequer. In considering fining mechanisms in the future, and consistent with the increased priority which say a primary duty to protect consumer interests would give, I would expect greater emphasis to be given to developing mechanisms which directly benefit users while at the same time giving the licence holder additional incentives to comply with its obligations.

Decision-making process and accountability

16. I have said in my very first annual report that "getting things right and doing them fairly is the business of efficient regulation". Both aspects are important. Decisions can be "right", but if they have not been made through a proper procedure they can be subject to judicial review. I therefore place considerable weight on openness in decision-making, involving consultation on major policy initiatives, followed by a statement of policy with reasons for accepting or rejecting material consultation responses, together with a clear statement of the criteria and procedures I will apply in respect of matters such as the approval of access agreements and the issue and enforcement of licences.
17. Although statutory powers lie with me as Regulator, in practice decision-making within ORR is collegiate, and designed to take full account of the range of internal views, as well as the views of external consultees on major issues. I have established a Council, which I chair, and which meets monthly. The Council comprises the Senior Management Team, including my Chief Legal and Economic Advisers, as well as three non-executives. These non-executives, who bring with them a broad range of transport policy, business and consumer experience, provide a valuable input on strategic policy developments and major policy decisions. I am able to seek advice from these non-executives between formal Council meetings on major policy issues as necessary, and consider that these arrangements provide an effective balance between the need for timely decision-making and excessive reliance on the views of a single individual.
18. The Council has recently reviewed the effectiveness of these arrangements, in particular to ensure that non-executives have the information and access to senior managers necessary to understand the basis of policy development and

implementation. This is achieved, for example, through quarterly written reports to the Council on policy implementation across the whole range of the Office's activities.

19. On some issues, in particular in respect of my approval of access agreements, I have made extensive use of hearings involving the parties to the agreement and others affected, including Government, OPRAF and Passenger Transport Executives. In a number of cases, these hearings have been formal and on the record, with a full transcript. These hearings have not been open to the public and transcripts are unpublished. Such hearings have proved a valuable opportunity to explore points of difference between the parties and possible ways of resolving them. Due process is particularly important on access issues given that the only statutory means of challenge to my decisions is through judicial review.
20. There is however a possible problem of reconciling the benefits of hearings with the need for speedy and cost effective decisions. Over time, and with agreement of parties including Franchising Director, less formal procedures have developed and an increasing number of decisions have been delegated downwards especially in those areas where a body of case law has started to emerge. In such cases, I have published a statement of the criteria and procedures that will be adopted in dealing with individual proposals³. I consider that hearings (either formal or informal) will continue to be used fairly widely by this office not only because of their effectiveness as a means of improving the decisions which I am required to take but also as a way of promoting transparency and openness of decision making.
21. I believe that the procedures which have been operating within ORR so far have generally been effective in promoting decision-making in the public interest. I will obviously wish to keep these arrangements under review, and to consider whether other approaches, including, for example, publication of and consultation on the Office's management plan, and the appointment of specialist advisory panels, could further enhance decision-making and accountability. In these matters, I pay particular attention to the procedural developments in other regulatory Offices, so that new approaches which improve the process of decision-making can be adopted. I am, for example, considering whether the role of the non-executives could be enhanced further, for example by providing opportunities for discussion with non-executives of

³ (Examples include Criteria for the approval of passenger track access agreements, second edition, March 1995 and Change of control of passenger train operators: criteria and procedures, March 1996.)

companies controlling licence holders. Other possible changes include the publication of their advice to me.

Customer representation

22. The legitimacy of regulatory decisions depends in part upon customers knowing that their interests are given the appropriate priority by regulators.
23. I welcome the close relationship between ORR and the Rail Users Consultative Committees. Under the terms of the Railways Act, I appoint the members of the Committees (although the Chairmen are appointed by the Secretary of State), and fund their operations. I can refer matters to them, as well as receiving from them for consideration matters which they are unable to resolve. The regional committees can therefore act as the local "eyes and ears" of regulation; the close relationship with this Office means that they are an important source of information on passenger perceptions and concerns. I would not consider that a separate national committee, on the lines of the Gas Consumers Council, would be as effective in bringing matters of concern to passengers to the attention of those with the powers to deal with them.
24. I believe that the role of the Consultative Committees could be further developed. For example, in my evidence to the MMC enquiry into the ScotRail/National Express merger, I suggested that any perceived detriments arising from the merger might be addressed through "regulatory objectives" for National Express, which the Scottish RUCC might monitor in respect of rail services. (Their remit does not extend to bus and coach services, although they would clearly be in a good position to review those aspects of performance as well).
25. The structure of the railway industry, with 25 train operating companies owned by 13 different groups, often providing overlapping services, presents a number of challenges in terms of devising an appropriate structure of passenger representation. It is important, for example that the Consultative Committees should be able to take an overview of services in a particular area; but at the same time there needs to be coordination between committees to ensure that matters relating to one company, or to companies under common control, are identified and resolved. With the assistance of outside consultants, I have recently reviewed the structure of the Consultative Committees, and I am in the process of reviewing arrangements by which coordination between committees in respect of individual companies is achieved. Other industries will face similar problems with the development for example of

multi-utilities and competition by regional electricity companies or water companies outside their "home" area.

26. Effective representation of customer interests requires clarity about responsibilities. The structure of the railway industry provides a challenge for passenger representation because of the confusion which having several different regulators can potentially cause. In my experience, there is not a problem with this where responsibilities are distinct and clearly allocated between different bodies. For example, this works effectively with the Health and Safety Executive who are responsible for the operational safety of the railways and with whom a Memorandum of Understanding has been drawn up clarifying our respective functions and duties. Problems can arise however where there are either overlapping responsibilities or split responsibilities between regulators. However, a number of customer protection functions in the rail industry are either shared between the Rail Regulator and the Franchising Director, or fall exclusively to one or the other. This has caused confusion in the minds of passengers, which undermines the credibility (even if not the effectiveness) of regulation.

Consistency between regulatory regimes

27. An important aspect of the Government's review of integrated transport policy will be whether the public interest will be better served by greater integration between the regulation of different modes of transport. I recognise that this is a legitimate and important question, which will be considered in detail as part of the separate review of transport by the Deputy Prime Minister. Whatever the outcome of that debate, I do not believe that there are sufficient similarities between transport, energy, water and telecoms to justify a formal "College of Regulators" as has been proposed by some commentators.
28. An important element of accountability for regulators is nevertheless to explain the reasons for their decisions, and in particular to highlight aspects of their decisions which may appear to be at variance to the approach of other regulators or the MMC. There are a number of issues in the periodic review of Railtrack's access charges which are common to other regulated industries and which I referred to earlier, for example, the use of a regulatory asset base, the application of MAR, the cost of capital and a PO reduction to share savings arising for reasons other than efficiency between shareholders and customers. I also highlighted my concern about the only significant process difference in the regulation of Railtrack compared to other regulated utilities namely the lack of appeal to the MMC.

29. If for what ever reason I am unable to introduce such an appeal mechanism in time for it to be applied to my findings in the forthcoming review, I will need to ensure through increased transparency and openness that the methodology I adopt is, where appropriate, consistent and can be seen to be consistent with that of other regulators. I do not consider that this is a matter of using the same answer, but it should involve using the same principles. There may be circumstances where different outcomes are appropriate, given the circumstances, but if those differences cannot be explained, the legitimacy of regulation will be undermined. The same principle applies to approaches to economic regulation more generally, for example, competition policy issues, complaints handling procedures etc.
30. I therefore welcome the informal arrangements now in place by which I meet with the other four regulators on a regular basis to discuss matters of common interest and to commission, and receive reports on, particular aspects of regulatory policy or practice. I believe these discussions could be made more effective:
- if there was a formalised remit for the group;
 - if there was external involvement (where appropriate from other regulatory authorities, government departments, industry the City, academics etc); and
 - if the conclusions which regulators reached on a particular aspect of regulation and the reasons for reaching the conclusions were published.
31. I also recognise the concern about the apparent discretion given to regulators in implementing the findings of MMC reports. However, if such discretion is to be reduced, a number of MMC processes would need to be modified to bring them into line with the standards which are now accepted as best practice amongst the sectoral regulators in terms of openness and transparency. In addition it would require the MMC to adopt a consistent approach to different enquiries, following established precedent; this could require a change in legislation. To ensure that proposed licence modifications were workable, it would also need to involve the sectoral regulator in developing its proposals. If this approach were to be adopted, it effectively requires the MMC to carry out an open consultation on the conclusions and modifications.

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Rail Regulator